Oil price increases seem to have accompanied every recession since 1971. Yet concluding that oil price shocks cause recessions is problematic because increases in the funds rate also have tended to precede recessions during this period. Are recessions caused by spikes in oil prices or by sharp increases in monetary policy?

Some analysts blame oil, but only indirectly. They conclude that recessions are caused not by oil price shocks but by the Federal Reserve’s tendency to tighten monetary policy in response to those shocks. The large funds rate increases preceding the 1975 and 1979 recessions are good examples. The funds rate increased dramatically as inflation took off during these periods, but since then there has been virtually no correlation between oil prices and inflation.

Possibly, rising oil prices cause inflation only if they are expected to be permanent. Although oil price futures are imperfect predictors of spot prices, we look to see if there is any correlation between inflation and the oil price increases that are expected to occur 12 months out. There does seem to be a slight correlation between expected inflation and future oil prices.

Although the data suggest that there is a small correlation between inflation and oil price increases, it is doubtful that oil was the primary cause of the huge inflation spikes of the 1974 and 1979 recessions. The question of whether recessions result from funds rate increases or from oil price increases is even more difficult. Perhaps recessions are caused by a confluence of both factors—the so-called perfect storm.